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No. 61

In the Supreme Court of the United States

OCTOBER TERM, 1930

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NIAGARA FALLS BREWING COMPANY AND PAUL A. SCHOELLKOPF, CHARLES E. HAEBERLE, ET AL., ETC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 25–35) are reported in 13 B. T. A. 1040. The opinion of the Circuit Court of Appeals (R. 46–50) is reported in 38 F. (2d) 217.

JURISDICTION

The judgment of the Circuit Court of Appeals reversing the decision of the Board of Tax Appeals was entered on December 16, 1929. (R. 51.) The

petition for a writ of certiorari was filed March 15, 1930 (R. 51), and was granted by this Court on April 28, 1930 (281 U. S. 712).

The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Did Congress intend by Section 234 (a) (7) of the Revenue Act of 1918 to authorize a deduction for obsolescence of tangible property in 1918 and 1919 caused by the imminence of prohibition legislation?

2. An alternative question is whether prohibition legislation caused a loss in regard to such tangible property in 1918 and 1919 which may be deducted under Section 234 (a) (4) of the Revenue Act of 1918.

3. The property which is the subject of the claimed deduction was used for the manufacture both of beer and near beer. Since prohibition legislation placed no restriction upon the continued use of the property for the manufacture of near beer, the question arises whether the deduction may in any event be allowed under the facts of this case.

STATUTE INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, 1078, provides in part:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax

imposed by section 230 there shall be allowed as deductions:

* * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * * * *

STATEMENT

This case reached the Circuit Court of Appeals on the petition of respondents for a review of the decision of the Board of Tax Appeals determining deficiencies in income and profits taxes for the years 1918 and 1919 in the respective amounts of $18,561.17 and $5,013.65. (R. 40.) The case involves the tax liability of the respondent Niagara Falls Brewing Company, which was a New York corporation. It was voluntarily dissolved on December 1, 1921, and its affairs in dissolution are being administered by its directors as trustees in dissolution. They are also parties respondent in the present proceeding. (R. 32.)

The evidence is not reported in the record. The following is an epitome of the findings of the Board, supplemented by certain facts which are stated in its opinion (R. 26–35):

Prior to national prohibition the taxpayer was engaged in manufacturing and selling beer. Its business and good will were created by such manufacture and sale. At the time of its organization in 1902 it acquired the buildings and equipment of a joint-stock association, the name of which it took. Later it constructed new buildings and installed additional machinery and equipment, which were constructed and designed for the manufacture of beer and were not available for or readily adaptable to other uses. (R. 26.) In 1917 the taxpayer began the manufacture and sale of a beer of alcoholic content of less than one-half of one per centum, known as "Pep" or "near beer" or "cereal beverage." (R. 31, 33.) In its manufacture the taxpayer used the same machinery and the same process which it had used in making alcoholic beer, except that in making near beer the additional process of "dealcoholizing" was necessary. The near beer had the same appearance as the alcoholic beer manufactured by the taxpayer, but did not resemble it in taste, nor did it have the same popularity. (R. 33.) In 1918 the taxpayer also began the manufacture of other soft drinks. This required machinery different from that used for the manufacture of beer and near beer, and no part of the allowances claimed by the taxpayer relate to property used for the manufacture of these other soft drinks. (R. 31, 27.)

In October, 1919, the taxpayer discontinued the manufacture and sale of alcoholic beer because of

national prohibition, but it continued to make and sell near beer. (R. 31.)

The taxpayer, upon discontinuing the manufacture and sale of alcoholic beer, considered the possibility of adapting its plant to other manufacturing or commercial purposes, but the construction and condition of the buildings and machinery rendered them unsuitable and not adaptable for other uses, and removal of the machinery was not feasible. (R. 30.) When the sale of alcoholic beer was discontinued, the taxpayer abandoned the lower floor of one of its buildings, which had been devoted to storing and aging alcoholic beer, as its use was not required for near beer. (R. 31–32.) Thereafter one-half of another building, with the equipment therein, which had been used three or four times a week in manufacturing and bottling alcoholic beer, was used only about once every two weeks in making near beer. (R. 32.) Apparently the rest of the plant continued to be used regularly for making near beer. But sales of this beverage declined after the effective date of the Eighteenth Amendment (January 16, 1920), although the taxpayer did not lessen its efforts to make sales of this product. (R. 31.) In December, 1921, the respondent corporation was voluntarily dissolved, as it could not operate its business at a profit. (R. 32.) In January, 1922, it leased all of its buildings, plant and equipment under a lease originally running for three months, which

was renewable at the option of the lessee and which had been renewed continually up to the time of the hearing before the Board in 1927. (R. 32, 1.) The plant was used by the lessee for making near beer. (R. 34.)

There is no finding that it became apparent to the taxpayer in 1918 or 1919 that its property could not be used indefinitely in the near-beer business after prohibition should become effective.

The following facts do not appear in the record, but the Court may take judicial notice of them: The National Prohibition Amendment was adopted by both Houses of Congress in December, 1917. In the first six months of 1918 twelve States ratified the Amendment. Three more States ratified it during the remaining six months of 1918. In the early part of January, 1919, twenty-one more States ratified the Amendment, and on January 16, 1919, it became part of the Constitution, although it did not become effective until a year later.

The taxpayer charged against its earnings and deducted in its income-tax returns the sum of $110,047.52 in 1918 and the sum of $57,139.99 in 1919 for obsolescence of its buildings, machinery, and equipment used in the manufacture and sale of beer. (R. 29.) These deductions represented the figure which the taxpayer's officials considered necessary to bring the assets down to an amount realizable upon a forced or liquidation sale after prohibition should become effective. (R. 29.) The value of all the property used in the manu-

facture and sale of beer at the end of 1918 and 1919 was less than its depreciated cost or book value after deducting the amounts charged off for obsolescence of such property during those years. The difference between the value in 1918 and 1919 and the depreciated cost of taxpayer's property on December 31, 1917, was due to the imminence and incidence of war-time and permanent prohibition legislation. (R. 33.) As the amounts involved on the different items need not be considered here, we do not refer to them, but they appear in detail in the findings.

The Commissioner of Internal Revenue disallowed the deductions claimed, on the ground that the taxpayer continued in a similar or related business after prohibition. (R. 18, 20.) The Board of Tax Appeals sustained the Commissioner's disallowance on this ground. (R. 34–35.) The Circuit Court of Appeals held that, upon the conceded facts, the amounts claimed for obsolescence were justified and should have been allowed, and accordingly reversed the determination of the Board. (R. 50.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

I. In holding that where tangible assets of a taxpayer decline in value as a result of prohibition legislation the taxpayer may deduct from income any amount as obsolescence of such assets under Section 234 (a) (7) of the Revenue Act of 1918.

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II. In holding that under the facts the taxpayer was entitled to deduct for the years 1918 and 1919 any amount for obsolescence of tangible property employed in the business.

SUMMARY OF ARGUMENT

The Revenue Act of 1918 does not authorize a deduction, either as obsolescence or as a loss, for the decline in value of property, whether tangible or intangible, resulting from the imminence and incidence of national prohibition legislation. The principle enunciated in *Clarke* v. *Haberle Brewing Co.*, 280 U. S. 384, is applicable here.

In any event there was no obsolescence in fact. To sustain a claim for deduction for obsolescence, it must appear that the taxpayer foresaw with reasonable certainty that the property would not be useful in his business or any other business, at some definite time in the future, when such property would have to be abandoned. There is no finding that this occurred during 1918 or 1919, the taxable years in question. Obsolescence results from a lack of usefulness and not from a lack of use. Here the taxpayer commenced to manufacture near beer in 1917, using the same property and equipment as was used to manufacture beer. The imminence of prohibition legislation did not justify the conclusion that it would affect the manufacture and sale of near beer or shorten the useful life of the property. After the adoption of national prohibition the taxpayer continued the manufacture

and sale of near beer. Its failure to use the property to as great an extent as before was due not to any lack of usefulness but solely to an absence of a large demand for the product.

There was no sale or abandonment of the property until 1928, and consequently there is no basis for the respondents' alternative contention that they are entitled to the deductions claimed in 1918 and 1919 as a business loss in those years.

ARGUMENT

I

CONGRESS DID NOT INTEND TO AUTHORIZE A DEDUCTION FOR OBSOLESCENCE OR LOSS OF TANGIBLE PROPERTY CAUSED BY PROHIBITION LEGISLATION

This Court has already decided that Congress did not intend by Section 234 (a) (7) of the Revenue Act of 1918 to authorize a deduction for obsolescence caused by prohibition legislation. *Clarke* v. *Haberle Brewing Co.*, 280 U. S. 384. The decision in that case was announced January 27, 1930, after the court below had decided the instant case. (R. 46.) Although the *Haberle* case involved the application of the obsolescence provision to good will, we submit that the reasoning is equally applicable to tangible assets. The Circuit Court of Appeals for the Second Circuit in its latest decision on the subject has so held. *V. Loewers Gambrinus Brewery Co.* v. *Anderson*, 42 F. (2d) 216, now pending in this Court upon a writ of certiorari granted October 20, 1930, No. 352, October Term, 1930.

In the *Haberle Brewing Co.* case, this Court said (pp. 386–387):

> In our opinion the words now used can not be extended to cover the loss in this case and it is needless to speculate as to what other cases it might include. It seems to us plain without help from *Mugler* v. *Kansas,* 123 U. S. 623, that when a business is extinguished as noxious under the Constitution the owners can not demand compensation from the Government or a partial compensation in the form of an abatement of taxes otherwise due. It seems to us no less plain that Congress can not be taken to have intended such a partial compensation to be provided for by the words "exhaustion" or "obsolescence." Neither word is apt to describe termination by law as an evil of a business otherwise flourishing, and neither becomes more applicable because the death is lingering rather than instantaneous. It is incredible that Congress by an Act approved on February 24, 1919, should have meant to enable parties to cut down their taxes on such grounds because of an amendment to the Constitution that it had submitted to the legislatures of the States in 1917 and that had been ratified by the legislatures of a sufficient number of States the month before the present Act was passed.

Renziehausen v. *Lucas,* 280 U. S. 387, presented the same question as the *Haberle* case and was decided upon the authority of that case. The right

to a deduction for obsolescence of certain tangible property, as well as for obsolescence of good will, was involved in the *Renziehausen* case. The following facts appear in the record in that case, although they are not stated in the opinion of this Court: In his appeal from the Commissioner's determination, Renziehausen claimed the right to a deducion for obsolescence of good will and also of his plant, equipment, and warehouses for the years 1918 to 1921, inclusive. The Board of Tax Appeals allowed a deduction in 1921 on account of the obsoleteness of plant and equipment (not including warehouses), caused by the enactment of the Willis-Campbell Act on November 23, 1921, and further held that obsolescence of the warehouses began in 1921 and that the taxpayer was entitled to such deductions in 1921 and 1922. The Board disallowed deductions for obsolescence of good will and of the tangible property in 1918, 1919, and 1920. On appeals by both parties, the Circuit Court of Appeals for the Third Circuit affirmed the decree of the Board. The taxpayer alone applied for a writ of certiorari. In this Court the Government opposed the allowance claimed for obsolescence of the tangible property in 1918, 1919, and 1920 (and claimed in the alternative as a business loss) on the ground that the enactment of the Willis-Campbell Act in 1921 was unforeseen and therefore that obsolescence had not commenced in 1918, 1919, and 1920. The Government also opposed any allowance for obsolescence of good will. This Court said (p. 389):

> * * * What has been said in the *Haberle Crystal Springs Brewing Co.'s* case is sufficient to dispose of this one, and here there is the additional fact that in 1919 the petitioner became aware that he could manufacture whiskey for medicinal purposes and did so until the Willis-Campbell Act of November 23, 1921, c. 134; 42 Stat. 222, was passed and the petitioner failed to obtain a permit under it. The evidence does not seem to warrant an alternative claim under the Revenue Act of 1918, § 214 (a) (4), for losses incurred in business in 1919, even if otherwise it could be sustained.
>
> * * * The petitioner has no reason to complain of the allowance for obsolescence of the warehouses.

In view of the contentions of the Government in that case, we are not certain that this Court intended to deny the deduction for obsolescence of the tangible property upon the same ground upon which it denied the deduction on account of good will. But regardless of what was decided there, we conclude that the broad ground of decision of the *Haberle Brewing Co.* case is applicable to the deduction claimed here.[1] And it seems obvious that

---

[1] There are several early rulings of the Bureau of Internal Revenue holding that deductions were proper for obsolescence resulting from prohibition legislation. See 1 Cumulative Bulletin, April–December, 1919, pp. 125, 127, 133; 2 Cumulative Bulletin, January–June, 1920, p. 143; 5 Cumulative Bulletin, July–December, 1921, p. 142; III–1 Cumulative Bulletin, January–June, 1924, p. 148.

Congress had no different intent with respect to losses under Section 234 (a) (4) than it had with respect to obsolescence under Section 234 (a) (7) (pp. 2–3, *supra*).

II

EVEN IF THE STATUTE SHOULD BE CONSTRUED TO PROVIDE FOR DEDUCTIONS FOR OBSOLESCENCE OR LOSS OF BREWERY PROPERTY CAUSED BY PROHIBITION, THERE IS NO GROUND FOR SUCH A DEDUCTION HERE, AS THE PROPERTY FOR WHICH THE DEDUCTION IS CLAIMED WAS ALSO USED IN THE MANUFACTURE OF NONINTOXICATING BEER

We contend that there was no obsolescence in fact during 1918 or 1919.

Obsolescence is the state of becoming obsolete. Property is obsolete when it is no longer useful for the purpose for which it was acquired and can not be used for any other purpose. From its very nature, obsolescence begins only when there is a reasonable certainty that the property will become obsolete. As the Circuit Court of Appeals for the Ninth Circuit said of obsolescence in *Lassen Lumber & Box Co.* v. *Blair*, 27 F. (2d) 17, 18–20:

> * * * in no case can a deduction be demanded for an anticipated depreciation of that character until there is a reasonable certainty that it will take place. * * *
>
> * * * * *
>
> * * * the taxpayer can not require proof that the requisite contingencies will not happen; but the burden is upon it to

> establish with a reasonable degree of certainty that they will occur * * *.
>
> * * * Depreciation from day to day and year to year, resulting from wear and tear or other physical deterioration, is susceptible to present estimate. But in a sense the depreciation here claimed does not accrue until the end of the period of use; presently it is constructive only. While upon the assumption that the loss will, in fact, be incurred, it is but fair to spread it ratably over the entire period, it is also only fair to require that it be shown by a preponderance of proof that its occurrence in the future is reasonably or practically certain to take place. A possibility or mere probability is not enough. * * *

Whether property is becoming obsolete is a question of fact. The burden was upon taxpayer to show that it was entitled to the deduction which the Commissioner had disallowed and that the additional tax was to that extent illegally assessed. *Botany Mills* v. *United States*, 278 U. S. 282, 289–290; *Reinecke* v. *Spalding*, 280 U. S. 227, 232–233; *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 361.

There is no finding that at any time during the taxable years in question it became apparent that the property would become obsolete, and we submit that no inference to this effect can properly be drawn from any of the facts which are recited.

We do not deny that it was apparent as early as 1918 that prohibition was imminent, but this would not prevent the taxpayer from manufacturing near beer, and there is little in the record to indicate what the prospects for success in this business were in 1918 and 1919. The taxpayer evidently began the manufacture of near beer or cereal beverage in 1917. A tabulation of sales of its products shows that the "sales" of this beverage (probably meaning deliveries) were very small until 1920, when they became substantial, and that they fell off materially in 1921. (R. 30.) The findings also state that after the Eighteenth Amendment became effective (January 16, 1920) the taxpayer's "sales" (probably meaning new contracts for sale) of near beer declined. (R. 31.) It was evidently not until some time in 1921 that the taxpayer came to the conclusion that it could not operate its business at a profit. (R. 32.) Although it seems fair to call attention to the statement in the findings that assets of a similarly situated brewing company at Niagara Falls were sold for a very low sum in 1919, and apparently the market was flooded with brewing machinery then (R. 28), these considerations do not seem to us sufficient to establish the position which the respondents must take.

The business of manufacturing near beer was in all essential respects of the same character as that of making alcoholic beer, except that the man-

ufacture of near beer required the additional process of "dealcoholization." The same buildings, machinery, and equipment were used by the taxpayer and, after its dissolution, by its lessee in making near beer which had been used in making beer. It is true that one floor of one building was not used after the cessation of beer brewing and that a part of another building was used much less frequently after prohibition. But it does not appear that these buildings were not useful for manufacturing near beer. Their disuse resulted from the lack of necessity for full use of the plant. They were not obsolescent, but were idle simply because of decreased volume of business. We submit that obsolescence can not be predicated upon a mere lessening of use. The failure to use machinery or a building to its full capacity should not support a deduction for obsolescence.

The court below did not discuss the point now under consideration; nor did it advert to the statement in the opinion of the Board (R. 34):

> * * * If we were disposed to hold that obsolescence were allowable on account of abandonment of a part of a building, we do not have sufficient evidence to determine whether the amount contended for by the petitioner is correct or what the allowance should be. The contention therefore must be denied.

In *Renziehausen* v. *Lucas, supra*, the claim for obsolescence was denied on the reasoning of the

Haberle Brewing Co. case and because of the additional fact that the taxpayer continued to manufacture whiskey for medicinal purposes after national prohibition became effective until the enactment of the Willis-Campbell Act on November 23, 1921 (c. 134, 42 Stat. 222). The situation of the taxpayer in the instant case was similar in that respect to that of the taxpayer in the *Renziehausen* case.

The evidence does not warrant the alternative claim under Section 234 (a) (4) of the Revenue Act of 1918 (*supra*, p. 3) for losses incurred in business in 1918 and 1919. This provision necessarily requires that there be a complete and definitely ascertained loss, fixed by an identified event such as an actual abandonment, sale, or destruction of the property. *United States* v. *White Dental Co.*, 274 U. S. 398, 401; Cf. *Lewellyn* v. *Elec. Reduction Co.*, 275 U. S. 243, 246–247; *Lucas* v. *American Code Co.*, 280 U. S. 445, 449.

Ordinarily, there must be a sale or other final disposition of the property before it can be said that a deductible loss has been sustained. In exceptional cases where the usefulness of business assets is suddenly terminated and the business is discontinued, or the property is discarded or permanently abandoned, a deductible loss may result. But in the latter event there must be a complete and final abandonment of the property for which the

loss is claimed.[2] It was not until October 29, 1919, that the manufacture and sale of real beer ceased. (R. 30–31.) It is clear, therefore, that there could have been no loss in 1918. And we contend that, as the taxpayer continued to use, own, or lease the plant until it sold the property in 1928 (R. 32, 36), it could not take a loss on account of diminution of its value until that year, if ever.

Under these circumstances, it can not be said that respondent sustained a deductible loss in 1919. Cf. *Dick & Bros. Brewing Co.* v. *United States,* 67 C. Cls. 505. The most that can be said is that this property suffered a substantial decline in value, but "The statute obviously does not contemplate and the regulations * * * forbid the deduction of losses resulting from the mere fluctuation in value of property owned by the taxpayer." *United States* v. *White Dental Co., supra,* p. 401.

We therefore maintain that the taxpayer was not entitled to deductions in 1918 and 1919 for the decline in value of its buildings, machinery, and equipment, either as obsolescence or as losses sustained in such years.

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[2] The regulations promulgated by the Treasury Department (*infra*, p. 20), under paragraphs 4, 5, and 6 of Section 214(a) of the 1918 Act, relating to the deduction of losses, provided that a deduction on account of buildings could be made only when they were sold or "permanently abandoned or permanently devoted to a radically different use," and as to machinery only when sold or "when its use as such is permanently abandoned."

CONCLUSION

The decree of the Circuit Court of Appeals should be reversed and the order of the Board of Tax Appeals should be affirmed.

Respectfully submitted.

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DECEMBER, 1930.

APPENDIX

Treasury Regulations 45, promulgated April 17, 1919, under the Revenue Act of 1918, contains the following:

> ART. 143. *Loss of useful value.*—When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation allowances) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where machinery or other property must be replaced by a new invention, or where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories

or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income. But see articles 181–188.

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